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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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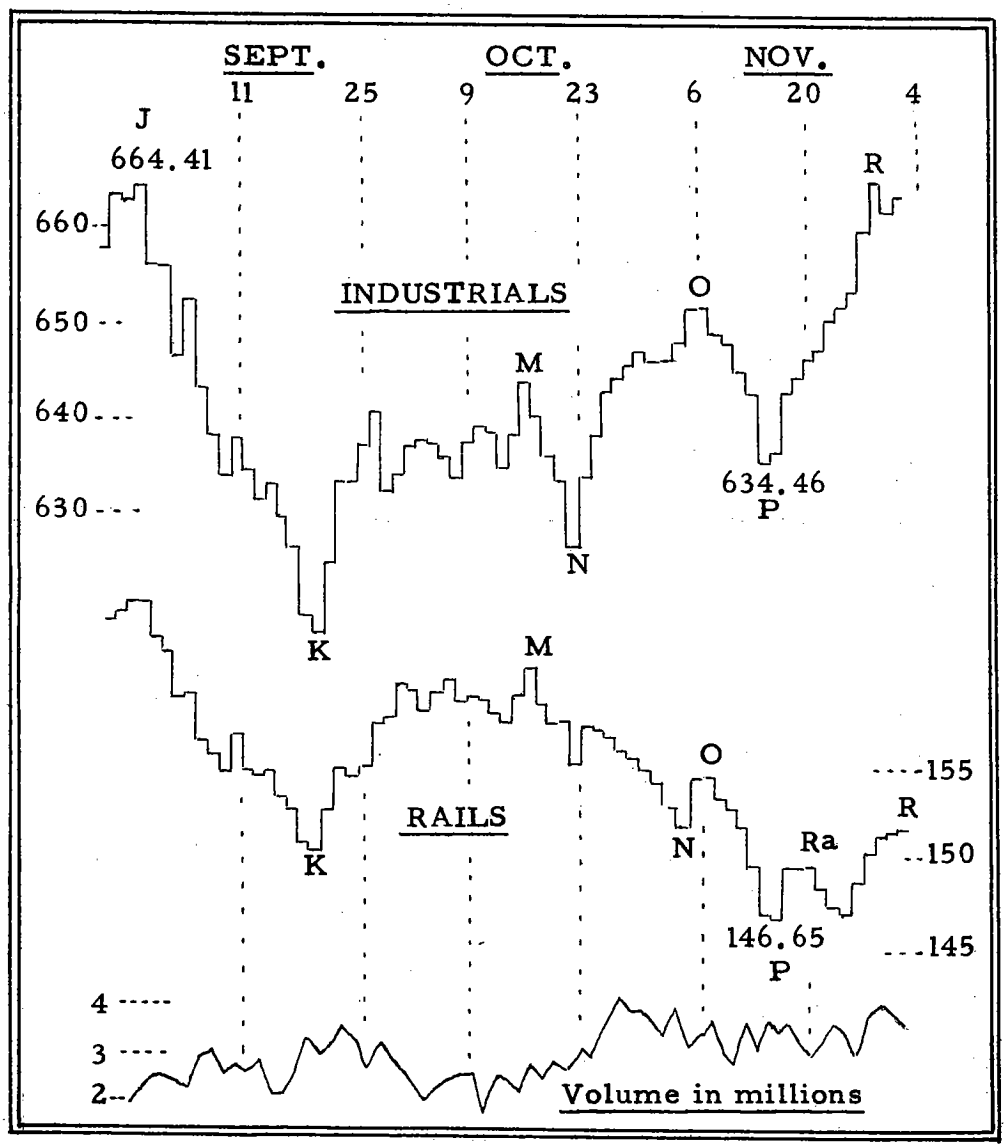
APPRAISAL. For five months the Averages have been appraising the many complex factors which go to make up the American economy. A great bull market was interrupted on July 8, 1959, the day when both Averages registered their last confirmed highs. In the period since then, the two Averages established secondary reaction lows (September 22, Industrials 616.45, Rails 150.28), following which Industrials rose to a new recovery high while Rails turned down and violated their September lows.

There is only one factor which can exert a lasting bullish force on the stock market barometer -- this is a forthcoming improvement in the nation's economy. For this reason, before both Averages can better their July-August highs (Industrials 678.10, Rails 173.56) the underlying factors which affect business and security prices must turn fundamentally more constructive than they were in July, 1959. Although the Dow Theory states that we are now in a bull market, the primary trend can only be reaffirmed as bullish if both Averages are able to better their former highs. A bettering of the old highs by one Average with the other advancing in the same direction would be a hopeful sign, yet the final proof lies in confirmation by both Averages.



PRICE MOVEMENTS. The Industrial Average has built an impressive structure since hitting its low point at K. The series of ascending zig-zags (K-M-N-O-P-R) or successively higher bases and peaks presents a most bullish picture. Indeed, if Dow Theorists could draw conclusions from the action of a single Average, there would be no denying the strength of the current market.

The "fly in the ointment" has been the Rail Average. I have written repeatedly that valid conclusions regarding the price movements can only be drawn when both Averages move together as if locked "in gear" and when both Averages are of a dis-

position to confirm each other (penetrate corresponding points).

Rhea wrote, "The most useful part of the Dow Theory, and the part that must never be forgotten for even a day, is the fact that no price movement is worthy of consideration unless the movement is confirmed by both Averages. Many who claim an understanding of the Theory consider only the movement of the Industrial stock Average if they happen to be trading in industrials. Some even chart only the one Average and profess to be able to interpret the movements correctly. It is true that there are times when such conclusions seem to be justified, but over any extended period such procedure inevitably results in disaster."

The M-P Rail decline persisted in the face of Industrial strength, and for this reason, I have repeatedly written that bullish conclusions based on the Industrial action alone must be held in abeyance.

CURRENT MARKET. Letter 85 stated: "A significantly bullish movement would be an Industrial bettering of O with Rails bettering first Ra and then O". Following the Rail low point at P, that Average formed a minor upward zig-zag, and this "in gear" movement provided the first hint of carrier strength since mid-October. Last week's Industrial penetration of O followed by the Rail bettering of R set off a wild buying spree which took Industrials to new recovery highs of 664.38 (point R).

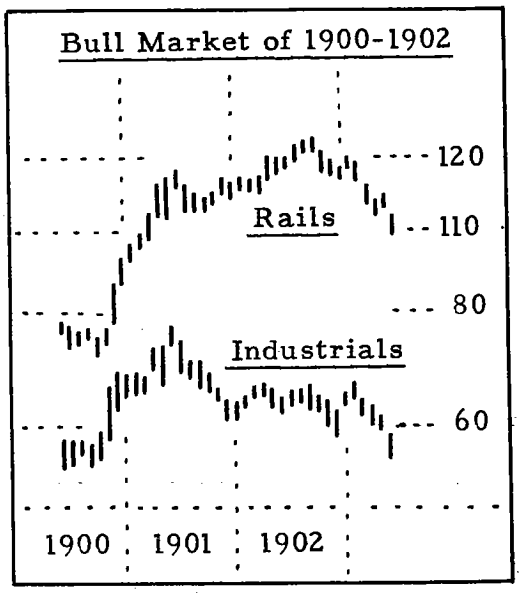
The series of upward zig-zags in Industrials together with the recent minor zig-zag in Rails allows us to infer that the secondary trend is in the process of turning up. But the secondary trend will only turn up in the true Dow Theory sense if and when Rails better their preceding peak at M (159.99). A persistent refusal on the part of Rails to approach or better M could be a warning signal worth watching.

The P-R advance accounted for gains of 28.92 points in Industrials and 4.66 points in Rails. Interestingly enough, on this advance Industrials halted just 3¢ (!) short of their former peak at J (see chart, J-664.41). Point J is therefore one obvious hurdle between here and the all-important Industrial bull market high of 678.10.

Because the P-R rally has lasted ten consecutive days it would be normal for a correction to occur at any time. As a rule, the more violent an advance the sharper the correction, and a decline correcting 1/3 to 2/3 of the ground gained since P would not be unusual. If volume tends to contract on such a decline the implications would be bullish and a buy-spot could be easily recognized. A bettering of R (664.38) by Industrials with Rails moving in direction or preferably bettering their own O point (154.14) would imply an attack on the Industrial high of 678.10 established last August. Conversely, a violation of the recent P points on increasing volume would spell important trouble ahead.

Since the September 22 lows, bulls on the industrials have fared considerably better than bears. Rail buyers, on the other hand, have had a frustrating time of it. I have always considered a "buy-spot" as an area where, following a decline or a reaction, the market turns dull at levels near the last lows. Purchases executed in such an area generally work out well, and there is a built-in safety factor in that those purchases can be dumped with slight loss if the Averages turn down and break the preceding lows. A review of the price movements since the September lows (K) discloses no such spot.

Experienced traders know that they cannot catch every market advance, and the recent move is a case in point. The lack of an identifiable "buy-spot" coupled with the unsatisfactory rail action meant that few Dow Theory traders were inclined to jump in on the rally.



THE BULL MARKET OF 1900-02 AND THIS ONE. In earlier Letters I said that I expected the Rail Average to confirm the primary bull market by eventually bettering its 181.23 bull market high established in 1956. Subsequent to the 1956 highs (Industrials 521.04, Rails 181.23) a great secondary reaction took place. That secondary bottomed out in late 1957, following which an historic primary swing advanced the Industrials to a new all-time high in August, 1959 (678.10). Rails on that advance touched a high of 173.56 (July, 1959), but as yet the Rail Average has not bettered its former 1956 high. Until this occurs, the 1957-59 swing will not be confirmed in a primary sense.

The question then arises, "Isn't it logical to expect that Rails will better their 1956 high before this bull market tops out?" It had been my opinion that the Rails would confirm, yet I do not wish to appear dogmatic. In Letter 77 (September 4, 1959) I stated that if a bear signal were given prior to a rail confirmation, I would take that signal as being valid and therefore conclude that the bull market was over. I quoted Rhea as my authority.

I received many letters from subscribers asking if there was any precedent for such a phenomonon. There is, in fact, one such precedent. In June, 1900, a bull market began with Industrials at 53.68 and Rails at 72.99 (Rails were the higher priced Average in those days -- see chart). On May 1, 1901, Industrials hit a high of 75.93 and Rails a high of 117.86. This proved to be the last confirmed high for that bull market. Although Rails continued upward and registered a final high of 129.36 on September 9, 1902, Industrials did not better their earlier 75.93 peak throughout the rest of the bull market.

"Without explaining why he did so," wrote Robert Rhea, "Hamilton selected September 9 as the termination of the bull market. While that selection does not seem to be an entirely logical one, Hamilton was alive to the situation prevailing at the time, and, having nothing better to offer, I accept his decision on the termination of a great bull market, even though the actual high in the industrials occurred more than a year earlier....when that average was 10.49 points above the price existing at Sept. 9."

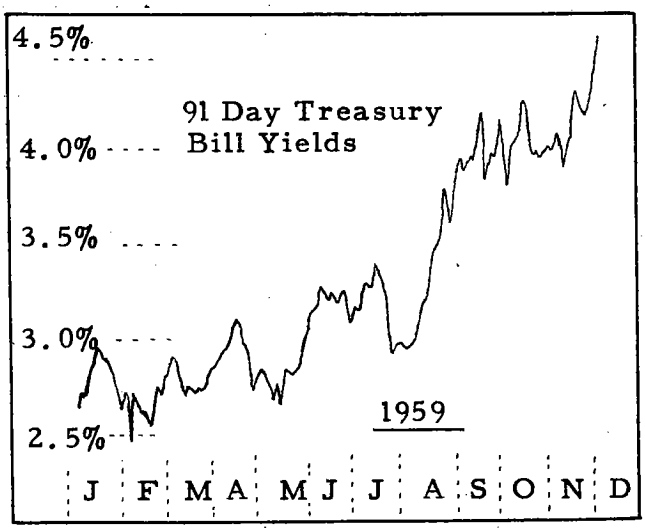
Rhea continued, "In the minor and secondary implications the two averages confirmed fairly well, but in the primary sense confirmation was lacking." Readers will note that this statement applies exactly to today's market.

"Fortunately," Rhea concluded, "no such situation has ever developed elsewhere in the averages, and, if a similar one should occur again, I sincerely hope I will not then be trying to interpret the voice of the averages." Rhea, of course, never lived to face the problem. If this bull market ends before the Rails better their 1956 peak of 181.23, however, the unique example of 1900-02 will have been repeated.

Perhaps this merely points up the fact that a perfect set of laws will never be developed for the stock market, and this is all to the good. For an infallible system would end all speculation and break every exchange in the world. And if we could be sure that this bull market would not top out before a final Rail confirmation, we could buy the Rails with the knowledge that we would have guaranteed profits.

(Note: the fundamental reason for Industrials' lagging behind Rails in 1902 was Theodore Roosevelt's trust busting activities. This sensational program did not affect the Rails nor did it halt the bull market, but it did provide a continual cloud of uncertainty for holders of Industrial shares.)

PRESSURE. Regardless of the pros or cons of a broad bull market in common stocks, there is one market that is unquestionably in a bull swing -- this is the market in U.S. Treasury bill yields. Few investors follow this most sensitive indicator of short term money rates, yet the chart below illustrates the tremendous pressure which has been exerted on money rates during 1959. From a 2.65% yield in January, 1959, the price that the Treasury has to pay for their shortest term obligations has sky-rocketed to last week's all-time high of 4.58%. Most interesting is the way in which the 91 day bill yields consolidated (rather than weakened) during the period of the steel strike, then broke out to historic highs. In Letter 81 I commented, "When the steel strike ends, a surge of new pressure will undoubtedly hit the money market. This should give us some extremely interesting money rates." This is exactly what has happened over the last few weeks. When the bull market finally runs into serious trouble, there are many who believe that the trouble will stem from the high cost of money and its impact on the economy.



TECHNICAL NOTE The balance of odd-lot transactions was on the cautious side during the recent P-R rally, and this implies that the public (as represented by the under-100-share trader) is quite skeptical of the possibility of higher prices to come. Technically, this is a plus factor in the current picture.

(Written - December 3, after the close)